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The effects of an earthquake are, in part, a function of the strength of the original shocks, in part, a function of the buildings affected. So in the economic system the effects of fluctuations, whether cyclical or otherwise, are in part a function of the magnitude of the original change, in part a function of the elasticity of the economic organisation affected.

Professor Lionel Robbins, *The Great Depression,* Macmillan & Co., 1934

THERE WAS NO NEW ECONOMY

Even before the outrage in New York, the world economy was on the brink of a concerted recession. After nine months of the Fed's most aggressive interest-rate cutting ever, the news on the U.S. economy and corporate earnings was becoming ever gloomier. But the news was readily shrugged off with the argument that the coming economic recovery in the United States was only a question of time. Expectations and forecasts have remained amazingly positive. For sure, there is little understanding of the looming economic and financial problems.

It has to be realized that Fed Chairman Alan Greenspan's aggressive rate cuts are proving to be a complete failure. At the very least, they ought to have invigorated the U.S. stock market long ago. Instead, U.S. stocks are leading a free fall of stock markets around the world. This is without precedent in the whole postwar period. The direct effects of the terrorist attacks in New York and Washington, however costly in terms of human life, are economically trivial. But they came at a time of weakness and great vulnerability for the American and the world economies.

Tracing the U.S. economic development, our focus has been and remains on the collapse of profits and capital spending as the key forces driving the downturn. Second-quarter profits before tax declined from a year earlier. It was the steepest year-over-year drop in 21 years.

As we shall explain, the outlook is for a continuing decline.

Business chiefs around the world are not hiding how scared they are. Many of them readily admit that the downturn's speed and breadth already exceeds any past experience. Ironically, their drastic cuts in capital spending happen to be its main cause. U.S. business fixed investment was down 14.6%, annual rate, in the second quarter of 2001. Within the total, equipment investment fell 19.8%, annual rate, from the first quarter. The biggest loser was information-processing equipment, with a decline of 35.3%, annual rate, following a 28.2% decline in the first quarter. Nonresidential construction also fell for the first time in seven quarters, clearly marking a peak for the cycle.

Plainly, business fixed investment is the epicenter of the U.S. economy's sudden sharp slide, setting it fundamentally apart from all previous experiences with the business cycle in the postwar period. Past recessions reflected little more than the correction of excessive inventories that had been run up during the prior upturn. Inventory recessions, though sometimes pretty violent, were by their nature limited in time. For obvious reasons, there is a general inclination to discard the present downturn as just another cyclical inventory recession.

Principally, any recession is a crisis of adjustment. The things to be adjusted are the dislocations in the economy's structures of demand and output that have accumulated during the prior boom, mainly owing to underlying credit excesses. On the pretext that the new information technology had substantially increased the U.S. economy's non-inflationary "speed limit," Mr. Greenspan allowed and fostered credit excesses of

unprecedented magnitude, and the inexorable results were imbalances and maladjustments in the economy and its financial system of equally unprecedented magnitude.

We have been tracking this development for years with highly critical comments, warning of disastrous long-term implications for the economy and the financial markets. In this letter, we have undertaken a comprehensive review of the U.S. economy's pattern of growth during the past several years. It shows and explains that the stellar performance of the GDP aggregate during these years has disguised major, pernicious changes in its composition, that is, in the allocation and use of existing resources — away from capital spending and towards chronic overconsumption.

Another most important issue is the propensities of the new information technology to create economic growth, general prosperity and profitability of businesses. A comparison with the qualities of the Industrial Revolution in these respects leads us to highly negative conclusions.

IT IS INDEED DIFFERENT THIS TIME

After all, when was the last time the Federal Reserve cut interest rates eight times in a row and the stock market still kept falling? In past economic downturns, the stock market began to rebound within about three months after the Fed had begun lowering its rates. Who has ever heard of residential construction rising to a new high while business fixed investment is plummeting? Why have corporate profits been plunging since 1997, even though the economy kept booming?

It is indeed very different this time. Apparently, lots of unusual features in the economy and the financial markets need close scrutiny. What we note, however, is a great urge to forecast the forthcoming U.S. economic recovery but very little or no true investigation of the particular forces underlying this unfamiliar economic downturn. A broader view, focusing on the economy's extremely weak fundamentals and brewing financial troubles, is completely lacking.

As to the U.S. economy's further prospects, there is, in our opinion, far too much fuss about consumer confidence and far too little attention to the dominant role of the extraordinary profits carnage, which has forced businesses to slash their investment spending. What has developed is a tug-of-war between plummeting profits and capital spending in its wake on one hand and consumer borrowing on the other. Since consumer incomes implicitly shrink in line with declining production, consumer borrowing is essentially holding the key to sustained consumer spending. Which of the two will win the day? Plunging capital investment or sustained consumer borrowing spending? We have no doubt that rapidly weakening consumer spending is the impending surprise.

The single most important, most unusual and also most ominous feature in the U.S. economic development during the past few years has been the steep drop in profits, which started at the pinnacle of the boom. It's definitely the downturn's one key cause. Everything else — the protracted plunge of stock prices, the savage cuts in business capital spending and the shrinkage of consumer income growth — is but a consequence of the profit carnage.

The other forces presently demolishing U.S. economic growth and prosperity relate to the many kinds of atrocious imbalances and distortions imparted to the economy and its financial system through the unprecedented credit profligacy: near-zero personal saving, the monstrous trade deficit, strained balance sheets, gross financial leverage, inflated asset values, soaring interest obligations and shrinking corporate cash flow. As a result, many recent economic developments cannot be explained by traditional business cycle dynamics. Most forecasts that are predicting a recovery are simply exercises in pattern recognition. If it always happened in the past, it is bound to happen again this time.

BACK TO THE PROFITS CARNAGE

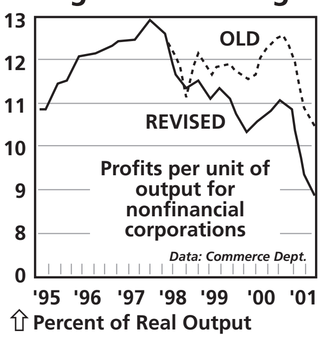
During the years 1997-2000, the U.S. economy has persistently grown at a rate slightly above 4% per year.

It was the best growth performance in decades for nonfinancial corporations. But oddly, it had no counterpart in profit performance. It was the worst profit performance ever during boom years, and now it is being followed by an unusually steep fall. Even though the economy has barely entered recession, profit margins are already at their lowest level in almost 10 years. If the National Income and Profit Accounts treated software outlays as an expense, as it did back then, profits would be below their recession trough of 1991.

In the last letter, we reported the savage downward revision of profits going back to 1998. The new data reveal a profits disaster. Domestic profits of non-financial corporations were revised down an average of 23%. These profits hit their peak in the fourth quarter of 1997 with $517.5 billion. From there they steadily declined, hitting their first low in the third quarter of 1999 with $446.2 billion, followed by a recovery to $518 billion in the second quarter of 2000. A year later, in the second quarter of 2001, they were down to $394.3 billion. At this amount, profits are below their level in 1995.

Importantly, this overall decline of profits conceals grossly differing movements between sectors. The biggest loser, by far, is manufacturing, with profits down from $197.5 billion in the fourth quarter of 1997 to $90.4 billion in the first quarter of 2001, or 54%, accounting virtually for the whole decline. Among the other sectors, the picture is very mixed. Not surprisingly, construction and retail sales, the obvious major beneficiaries of the housing and equity bubble, performed by far the best in profits.

The Profit Squeeze Began a While Ago



The Commerce Dept. has dramatically revised down corporate profits. Operating earnings in the first quarter now total $789.8 billion less than the old data showed. What's more, the profitability of non-financial companies, defined as the earnings generated per unit of output, is at its lowest level since 1993, suggesting that margins are under extreme pressure.

Source: Business Week
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As overall profitability has plunged, so have earnings per share. In the second quarter, the S&P measure recorded its largest year-over-year decline in the whole postwar period.

TWO MAIN CAUSES

Looking at the past few years, what effectively calls for investigation and explanation in the U.S. economy's case is a profits disaster rather than the profits miracle that has been trumpeted. At bottom it also flatly contradicts the trumpeted productivity miracle. Both inherently move together. It was in particular the poor profit numbers, in fact, that first aroused our doubts about the alleged productivity miracle. Considering the central role of profits in the economic growth process, the cause or causes of this profit malaise essentially pose the next imperative question. U.S. government statistics about prices, costs and profits per unit of output make a precise answer possible. They are found in the Economic Indicators, published monthly by the Council of Economic Advisors.

The favored, comforting explanation of the poor profit performance is a lack of corporate pricing power in America's highly competitive markets. American policymakers and economists like to boast of the low inflation rate. But at an annual rate of 3% and higher, the U.S. inflation rates are rather on the high side in the present international environment. We have identified a totally different explanation for the profit malaise.

Since profits slumped while the economy was booming, it goes without saying that profit margins have, implicitly, fared a lot worse. Profits per unit of output peaked in 1997. Since then, they have been in a steep, uninterrupted fall. In the first quarter of 2001, they were down 34%, and meanwhile they are probably at their lows of the recession years of the early 1990s, if not lower.

Just to give a few numbers. In 1997, unit profits from current production had been at 0.090. This figure was

up from 0.049 in 1991. During the first quarter of 2001, it had already fallen to 0.059. The single most important negative influence on the profit performance during these years, apart from labor costs, was a soaring corporate interest bill. Interest paid by firms of the nonfinancial sector swelled from $392.7 billion in 1997 to $521.9 billion in 2000. This compares with total profits of $491.8 billion for the sector in the same year. Next in taking an unusual toll on profits were soaring corporate depreciation charges, showing an unusual rise from $493 billion in 1997 to $606.9 billion in 2000.

These two expense items, a soaring interest bill and soaring depreciation charges, have clearly played a key role in squeezing profits. One question answered immediately begs the next one. What was it that sent these two expense items steeply higher? As to the extraordinary surge of the interest bill, it is important to see that it had very little to do with higher rates. Its overwhelming cause was a rampant rise of corporate borrowing. And as to the depreciation charges, it is important to see that their extraordinary surge accrued from a drastic shift in the composition of capital investment from traditional, longer-lived machinery towards shorter-lived assets, such as computers and software. Corporate America went long in debts and short in assets.

A STRUTURAL PROFIT SQUEEZE

We come to the final question in the matter of profits, the question of what effectively led to the extraordinary escalation of these two expense items in the U.S. corporate loss-and-profit accounts. Essentially and logically, it implies unusual changes in U.S. corporate strategies that specifically boosted these two expense items. As we have been stressing for years, the main cause or causes of this poor profit performance reside, ironically, precisely in those features of the New Economy that had been hailed as the harbingers of miracles in productivity and profits. They are: *first,* grossly misguided corporate strategies to boost profits; and *second,* a gross misjudgment of the economic effects of the new information technology. And clearly, both influences are structural, not cyclical.

As to the first fallacy, it refers, inherently, to those specific strategies that the shareholder value cult have been emphasizing and virtually imposing on corporate management as the presumably quickest and most effective devices to maximize profits and shareholder value. The result was the well-known collective shift towards mergers, acquisitions, downsizing and restructuring.

For years and years we have been warning that all these measures and strategies are no substitute for capital spending on new plants and equipment. They reflect a very narrow-minded microeconomic logic, focusing exclusively on inherent benefits to a single firm. From a macroeconomic perspective, however, they all are prone to reduce profits in the economy as a whole. As we have repeatedly pointed out, all these measures and strategies suffer from the famous "fallacy of composition": What is favorable for a single firm may be damaging for firms as a whole. The old economists used to be keenly aware of this crucial difference in perspective.

To illustrate the problem of applying micro logic to a macro situation, consider that for most firms, payroll expenses are the most important influence on profits. This suggests that cutting wage costs implicitly improves profits. That is indeed true for the single firm. But from the perspective of the business sector as a whole, it is different when done by many or even most firms. In the aggregate, lower wage expenses lead to lower business revenues as wage earners have less earnings to spend.

SHAREHOLDER VALUE FOLLIES

With time horizons for profit growth under the new shareholder value cult now shorter than ever, corporations stampeded into debt, retiring equity across the board through mergers, acquisitions and stock buybacks, while downsizing their capital spending on new plants and equipment. Why invest in capital stock when it is much easier to get earnings-per-share growth from stock buybacks? In the pursuit of quick riches, Corporate America embarked on a relentless ravage of its balance sheets.

What happened on the asset side of corporate balance sheets as counterpart to this borrowing binge? In

general, by paying for the purchased stocks of other companies vastly in excess of the book value of underlying real assets, the huge difference could not be expensed. It had to be capitalized as goodwill. Soaring shares of goodwill in corporate balance sheets became one of the most striking hallmarks of the new shareholder value cult. Unfortunately, the incurred liabilities involved steeply rising interest expenses, whereas the fictive asset of goodwill yields nothing. Stupidly, share prices were boosted at the expense of future profits.

In the same vein, this drastic financial restructuring went together with a drastic shift in the composition of business capital investment. As mentioned earlier, investment spending shifted massively towards very short-lived, new high-tech assets, chiefly computers and software, from which wonders of productivity and profit gains were expected. The essential further negative effect on profits in the longer run was the soaring depreciation charges that are now squeezing corporate earnings, while the productivity and profit miracles expected from the massive high-tech investments failed to materialize. Total net investments, adding to the capital stock, have remained rather small.

What is happening is pretty clear. After all, the short-term positives inherent to the corporate strategies implemented to lever shareholder value are being overtaken by inherent longer-term effects on business profits, capital spending and economic growth. What we are witnessing is not only the bursting of a bubble but the undoing of the shareholder value cult. All in all, this says that the profit squeeze is structural, not cyclical. Misguided financial restructuring and investment spending are backfiring on profit performance.

It is our long-held view that, from a macroeconomic perspective, the obsession with shareholder value in America is the greatest folly in economic thinking and theory in history. This devastating judgment arises mainly from two recognitions: *first*, that simply too many possibilities exist to manipulate reported profits and stock prices with a plethora of accounting tricks and other devices; and *second*, that these strategies widely implemented to lever shareholder value have effects that impair economic growth in the longer run. What appears to be excellent microeconomics is, unfortunately, very lousy macroeconomics.

MACRO AND MICRO PROFIT SOURCES…

Substantial relief for the corporate interest bill is, of course, forthcoming from the Fed's rapid succession of rate cuts. But immediate downward adjustments of interest rates on outstanding credit are confined to short-term lending by the banks and the money markets. In the first half of the 1990s, U.S. corporations enjoyed their most spectacular profit gains against the backdrop of slow economic growth, rising by 87% between 1990-1995. This was the profit miracle, but it derived completely from sharply falling interest costs and a low level of depreciation expenses, not from high tech.

What is next for profits in the U.S. economy? As we have repeatedly explained, our respective assessment is largely determined by tracing the specific macroeconomic flows of funds into and out of the business sector, producing business revenues or business expenses, thus affecting aggregate profits. All expenses reduce the net worth of a business, and all revenues increase net worth. Available figures for the last few months suggest that the fall in U.S. corporate profits is sure to accelerate.

Investigating these profit-impacting flows of funds, we distinguish between two different sets of influences. Again it is macro versus micro. The macro components relate to changes in the flows of funds related to government policies, that is, both to monetary and fiscal policy. The micro components relate to changes in flows reflecting the measures and strategies implemented by the corporations themselves.

The single biggest drag on U.S. corporate profits in the past few years, as we have repeatedly pointed out, has been the exploding trade deficit. It reduces profits because the payments for soaring imports to foreign producers are lost to domestic producers. Plainly, the corporations have no control over this negative profit effect. It arises, ultimately, from the strong dollar and the domestic demand excesses resulting from the credit glut, for which the Fed's monetary looseness is responsible.

But that credit glut stoked yet another force in the economy that has been bolstering the business sector's profit aggregate a lot more than the trade deficit was subtracting. The source of these flows was the unprecedented rampage of personal saving. Within just two years, personal saving plummeted from $301.5 billion in 1998 to just $67.7 billion in 2000.

All-important from the macroeconomic profit perspective is that credit-financed consumer spending, in contrast to income-financed spending, represents a net increase in revenue that has involved no prior expenses for the business sector as a whole. Although the soaring trade deficit diverted a considerable part of this spending flow to foreign producers, the big dissaving binge of the consumer was Corporate America's great profit bonanza during the last two to three years. Ominously, aggregate profits fell nevertheless.

…ARE TURNING HEAVILY NEGATIVE

More ominous is the compelling conclusion that the macro influences on U.S. corporate profits have, on balance, turned negative. The trade deficit has ceased to be a profit drag because imports are falling faster than exports. On the other hand, though, consumer dissaving, the former, far bigger, prop to profits, has also petered out. A burst in mortgage refinancing temporarily notched personal saving in May-June again, but other increasingly unfavorable influences on consumer incomes and confidence make a rise in personal saving a virtual certainty, turning it thereby into a major drag on business profits. Its steep rise in July to $191.4 billion (annual rate) from $70.4 billion in the month before mainly reflects the unexpected and unpleasant fact that the government's tax rebate ended overwhelming in savings accounts.

One of the most pertinent questions right now is by how much personal saving may rise again in the near future. Consider that a personal saving rate of just 1% of disposable income is presently equivalent to an amount of $75 billion. To put this into perspective, it seems reasonable to assume that individual households, facing huge losses on their stock market wealth, will in the next two to three years return to a saving rate of at least 2-3% of disposable income. Realize that the U.S. economy is right on the edge of potential disaster. By allowing and fostering those inordinate credit excesses that slashed the personal saving rate, Mr. Greenspan has put the U.S. economy and its financial system at unprecedented risk.

Financial troubles are spreading all over the U.S. economy and its financial system. Subprime consumer loan problems are surging. Many lenders who jumped into this rapidly expanding business are getting out or tightening lending standards. Financial companies have abandoned auto leasing. A relaxation of mortgage lending standards during the boom has led to the highest delinquencies in eight years. News of corporate labor-shedding is abounding. Consumer confidence in August fell to an eight-year low. In addition, consumers took on no new credit in July, after paying down their debts by $1.8 billion in June. Personal saving, to be sure, is turning from the big profit booster it was in past years to the great profit killer of coming years.

A BADLY FLAWED GROWTH MODEL…

We are coming to the microeconomic causes that have, in fact, been decisive for the poor profit performance. Implicitly, they relate to the specific measures and strategies that Corporate America has implemented in the past few years in its single-minded pursuit of maximizing shareholder value in the short run.

We already mentioned the substantial, longer-term negative consequences of these strategies for corporate interest bills and depreciation charges. But the profit problems in the United States go far deeper than that. They have their root cause in the badly flawed concepts about what effectively creates the profitable economic growth and prosperity that Wall Street has too successfully propagated in the past couple of years.

In line with the traditional economic consensus, it has been our unwavering persuasion that adequate capital accumulation is the one key condition for satisfactory economic growth. Capital investment creates demand while the capital goods are under production, and it adds to capacity when finished. Once installed, the new

plant and equipment increases supply by directly adding to production capacity and indirectly by contributing to productivity growth through technical innovation. But there is yet another important effect from the capital spending. Normally, it is the business sector's largest and most important profit source.

For generations of economists from all schools of thought it has been an unquestioned fact that capital spending and saving are the indispensable and sufficient conditions for economic growth. Capital spending, matched by saving, is the mother of all benefits. It creates demand and supply, it creates productivity growth and low inflation and it is intrinsically the main source of profits. But saving that releases resources from the production of consumer goods for the production of capital goods is the indispensable, complementary condition. That's old economics as known for more than 200 years.

It bemuses us that today's American economists are completely oblivious of the key role of capital investment in the economic growth process. Their panacea is productivity growth due to new technology. Strikingly, the words "capital spending" and "saving" are non-existent in their vocabulary.

We would say that the complete silence on these two growth ingredients has an obvious reason: both are badly lacking in the U.S. economy. The alleged miracles of the boom therefore needed another explanation. This explanation was conveniently found in the rapid pace of progress in new information technology, supposedly generating wonders of productivity and profits growth. Further credit for the alleged new paradigm shift is generally given to low inflation, corporate restructuring and very efficient capital markets, providing for unprecedented wealth to shareholders. Instead of seeing economic growth coming mainly from piling up ever larger stocks of factories, machines and equipment, Wall Street's new growth model sees *technology-driven productivity growth and wealth creation in the stock market* as the primary engines of economic growth.

In an article about the annual symposium of Federal Reserve policymakers in Jackson Hole, Wyo., we read the other day from Harvard professor Martin Feldstein, President Ronald Reagan's former chief economic advisor: *"The key question is whether productivity at 2.5% (annual increase) is going to continue. My answer is 'yes.' You have to look at the economy itself. The information revolution is going to keep us going."*

It is certainly an astounding assumption that sustained high productivity growth helps against recession, considering that in times of low growth it boosts unemployment. In another speech at the conference, Larry Summers, former Treasury secretary under President Bill Clinton, gave the equally astounding answer. In short: increased productivity, arising from the rapid pace of technological progress, means increased profits, which motivates businesses to invest ever more into the new high tech. As a result, he assumes, IT spending will grow as a share of GDP, and trend productivity will be as fast or faster than it was in the late 1990s. He reckons that the sustainable rate of productivity growth in the United States is around 3%.

Obviously, it has escaped him and many others that heavy investment in high tech over the past few years has terribly disappointed the high-riding expectations for profit growth that were put into it. Adding injury to insult, the earlier, impressive productivity figures were drastically revised downward. Instead of growing 3.4% in 1999 and 2000, as originally reported, productivity in these two boom years grew at a much lower average rate of 2.6%. Productivity growth to the second quarter of 2001 was even trimmed to only 1.5%.

PRODUCTIVITY GROWTH — BRIEFLY REVISITED

It is an old theme of this letter that the alleged productivity miracle of the past few years was a mirage, owing its appearance overwhelmingly to dubious statistical changes: hedonic price indexing of computers, capitalization of software and downward revisions in the consumer price index on the recommendation of the Boskin Commission. From a speech by Mervyn King, deputy governor of the Bank of England, also at the gathering in Jackson Hole, we learned a fourth reason: the extraordinary surge in depreciation charges.

Conventional measures of GDP growth, Mr. King argued, do not allow for the depreciation of capital assets — so they also exaggerate productivity gains. Net domestic product is the better measure. In normal circumstances,

GDP and NPD growth rates are identical, but in recent years they have diverged sharply in the United States because the corporate investment pattern shifted massively towards very short-lived assets, implying the observed surge in depreciation charges. A bigger chunk of the rise in output is simply replacing what has worn out. This should not be counted as a genuine productivity gain.

We did a calculation of the effect. It would have lowered the U.S. economy's growth by 15%, and that would have subtracted 0.4 percentage points from the recorded average productivity growth of 2.6% in 1999-2000. If you consider next that these were boom years, and further that those various statistical changes mentioned earlier have substantially bolstered GDP growth and also productivity growth, it becomes a compelling conclusion that trend productivity has hardly improved, if not even deteriorated.

On closer consideration, this single-minded emphasis by American policymakers and economists on technology-fueled productivity growth as the key engine of economic growth *makes no sense*. It puts the cart before the horse. To be sure, productivity growth is *the* indispensable condition for increased standards of living. In so far, it is crucially important. But always keep in mind that productivity growth on the economy's supply side needs increased demand to implement effective economic growth. The problem with productivity growth is that, by itself, it moves nothing in the economy, neither demand nor supply. What the productivity figures actually measure is *potential* economic growth. However, realizing the increased potential for growth requires increased demand. Sustained productivity growth during an economic downturn simply spells rising unemployment and falling consumer incomes.

In the traditional growth model, as explained, the major source of demand creation is capital spending. But if that is missing, it essentially needs an alternative source of demand creation. Over the last few years, American policymakers and economists discovered that source in the wealth effects of increasing stock and house prices. As Mr. Greenspan put it in a congressional testimony in 1998: *"Our economy is still enjoying a virtuous circle, in which, in the context of subdued inflation and generally supportive credit conditions, rising equity values are providing impetus for spending and, in turn, the expansion of output, employment, and productivity-enhancing capital investment."*

In his opening remarks to the Jackson Hole conference, Mr. Greenspan elaborated extensively on one single topic: changes in wealth effects as important determinants of consumer spending. Strikingly, he treated his subject completely in the abstract, explaining in detail how it works, expressing his particular interest in extractions of home equity for spending. In a footnote, he makes the comforting remark that *"in the presence of increased capital gains, unrealized but still perceived as permanent, debt capacity and levels are likely to rise."*

Reading his full speech, it struck us that he obviously wanted to convey the impression that consumer spending out of capital gains on equities or the home belongs to the normal pattern of economic growth. Apparently he has realized that the U.S. economy, with its low rate of net capital spending, needs a consumer who permanently spends more than he earns in order to provide for the necessary demand growth. Obviously, it has completely escaped him that what he talks about is the ugly essence of a bubble economy.

But just think of the whole idea: Prosperity and economic growth through extracting home equity. In actual fact, spending out of capital gains was in essence the U.S. economy's main source of growth in the past few years. The new paradigm economy was in reality a mixture of a bubble economy and dubious statistics.

NEW PARADIGM BUBBLE

During the past couple of years, we have endlessly read of the sweeping changes for the better in the U.S. economy. That's indeed the general perception. Our reading of the most important data tells us of the exact opposite, that is, of sweeping changes in the U.S. economy for the worse. It is an economy that has become entangled in massive capital consumption. Capital decreases when the community consumes more than it

produces. A decline in the saving rate is equivalent to a rise in the share of output in GDP that is consumed. And please do not think that the foreigners investing in the United States are contributing to new investment in productive capacity. They are buying existing U.S. factories. The ugly reality that few people see and understand is that America has been selling its factories to pay for escalating consumption.

The great boom lasted from end-1995 to its peak in the first quarter of 2000. Let's have a look at both sides of the coin, that is, at stock prices on the one hand and important changes in the economy on the other.

First to the eye-catching event, the stratospheric rise of stock prices: The Dow index soared during the period from 5,117.12 to 11,722.98, representing a rise by 129%. The S&P 500 took off from 615.91 to a peak of 1,527.45, or by 148%, and the Nasdaq skyrocketed by 380%, from 1,052.13 to 5,048.62. The net financial effect of the surging stock prices for the consumer was that the market value of his stock holdings, including mutual funds, soared from $5.3 trillion at the end of 1995 to $12.7 trillion in the first quarter of 2001, up 138%.

What happened in the economy at the same time that could have possibly justified this miracle in the stock market? U.S. real GDP rose overall 22.3%. Profits of nonfinancial corporations gained 28.3%. Though this was not bad, it definitely was not inspiring. Besides, barely one year later profits have already slumped to a level below that of 1995. It's a hard job to explain any relationship between stellar stock market performance and dismal profit performance during these years.

It is true that the economy did, actually, experience sweeping changes. The two most spectacular were that: *first*, personal saving plummeted from $302.4 billion in 1995 to $53.5 billion, annual rate, in the first quarter of 2000, respectively, from 5.6% to 1.3% of disposable income, and *second*, the deficit in the balance on current account soared from $109.9 billion to $432 billion (annual rate) in the second quarter of 2000. While today's American economists like to advertise the two occurrences as symptoms of economic dynamism, generations of economists would have regarded the collapse of saving as a macroeconomic disaster because it decreases the resources that are available for investment.

PROFITLESS TECHNOLOGY

From macroeconomics to microeconomics again. Now we come to the key flaws in the U.S. model of a new paradigm economy and also the chief causes of the shockingly poor profit performance. It starts with a narrow emphasis on innovation as a source of productivity and profit growth, as against the virtual disregard of the indispensable effects that capital spending, as such, directly imparts to economic growth and profit creation.

It appears to be widely assumed that the new information technology must be particularly favorable for profits because it is seen to generate unusually high productivity growth while requiring very little capital input, in contrast to the innovations in industrial technology that required a very high capital input. Many therefore seem to think of it as almost a free lunch. It is their pivotal error. From a macroeconomic perspective, and that's the one that counts in this matter, it is exactly the other way around. The industrial innovations produced such immense growth and prosperity in the form of plants and equipment because their production required immense capital accumulation.

Putting it precisely again: It is net capital investment, and net capital investment alone, that turns innovation into higher spending and higher incomes. The new information technology has had very disappointing profit effects across the board. Paradoxically, this has its main reason in the fact that it involves too little capital spending and capital accumulation. This leads to a devastating conclusion: The poor profit performance that we observe is structural, not cyclical.

Recently *The Wall Street Journal* (Aug. 16, "Heard on the Street") reported that the companies listed on the Nasdaq stock market had earned no GAAP profits since 1995, following massive write-downs in the past four quarters.

Believers in the wonders that technical innovation are prone to do to economic growth and profits like to

quote Joseph Schumpeter as their most renowned witness on this subject.

Indeed, he called *"innovation the dominant element which accounts for alternating prosperities."* But his whole argument allows no doubt that the associated waves of capital spending were, in his view, the crucial factor.

Capital investment is the one and only factor that provides for all effects needed for economic growth. It directly provides for higher demand, higher supply, higher productivity and higher profits. Altogether, this is what makes capital spending *the* key ingredient in the growth process. Technological progress may augment some of these effects, but capital spending is paramount. To be precise, it is net investment in current dollars that matters.

According to conventional measurement and perception, the U.S. economy experienced between 1997-2000 its biggest investment boom of all times. Fixed business investment increased $387.5 billion, accounting for a stunning 36% of real GDP growth. By far the greatest part of that boom, though, had accrued from the hedonic price index and the soaring depreciation charges. Both add nothing to profits. Only net investment, measured in current dollars, does. But with an increase by $193 billion, it has been badly lagging, accounting merely for 12% of nominal GDP growth.

As the Boston Fed disclosed late last year, corporate investment in computers and peripherals from 1995 to 1999 rose by 10% a year in nominal dollars — but by 45% in dollars adjusted by the hedonic price index. These adjusted dollars count in the numbers for GDP and productivity growth that move the markets. But there is no money involved that could add to profits. In actual fact, it is the very slow increase of net investment in nominal dollars that makes for the poor profit performance.

Why is capital spending of such great importance for profit growth? The reason, in short, is that it generates business revenue but no expense. In order to understand that, we have to return to macroeconomics: When a firm buys and installs a new machine, it incurs no expense until the first depreciation charge is recorded. To the firm that has produced and sold the machine, however, this transaction is a sale that has increased its revenue. Taking the business sector as a whole, the net effect of the two is a corresponding rise in aggregate profits.

It was particular to the industrial innovations that their implementation required huge capital investments, but this was precisely the feature that accounted for the burst in prosperity and profits that developed across the economies. It is only the building of new factories that creates new prosperity. Capital spending is the central, critical factor in the growth process, with or without innovation.

FALSE AND TRUE PROSPERITY

We come to another issue of central importance for a nation's economic future. It is wealth creation. Here, too, the narrow-minded micro thinking fails to recognize the gross macroeconomic fallacies in the American, Wall Street-inspired growth model. Never before have we read so much about wealth creation than in the past few years. Trillions of dollars accrued to the American public within an unbelievably short time from the rapid gains in stock prices.

It was new wealth, yes, but saying this, it is necessary to clarify what we are talking about. The burst in stock prices created wealth for the stock owners, but for them only, not for the economy as a whole. Generations of economists would never have thought of rising stock and house prices as "wealth creation." They would have derided it as pseudo or paper prosperity. For them, it was a truism that true wealth and prosperity could only accrue from saving and capital investment, increasing the stock of factories, machines and buildings, providing for more productive production in the future. Saving's indispensable function in this process is to release resources from consumption that are necessary to add, to improve and to enlarge the existing stock of productive capacity.

What, exactly, makes nations prosper? Just think of the past. Our ancestors took great efforts to build roads,

houses, factories and so on. These tangible assets, adding to the economies' productive capacity, were the national macro wealth they created, tending to enrich everybody. At the same time, the production of these capital goods created a large and growing part of the consumer incomes that buy the growing supply of consumer goods.

It was the extraordinary burst of capital spending in tangible productive assets that led to the extraordinary burst in prosperity in the wake of the Industrial Revolution.

These economists knew the crucial difference between increases in the *stock* of tangible assets adding to the economy's capacity to produce goods and incomes, and increases in their *market value*, inherently adding nothing to the economy's productive capacity. For them, the key question would have been how this increase in paper wealth would impact the utilization of existing resources in the economy. In case it gives a major boost to consumer borrowing and spending, as it did in the United States, they would have vehemently decried this as calamitous "capital consumption," essentially diminishing potential future economic and income growth.

It cannot be said, of course, that the new information technology is principally detrimental to economic growth and stability. Yet two things turned this technology into a looming economic and financial disaster for the U.S. economy: the absurd, euphoric stories about implicit miraculous economic effects of this technology stoking the stock speculation, primarily propagated by Wall Street; and the most inordinate money and credit creation that the world has ever seen, for which, of course, Mr. Greenspan is primarily responsible. Together, the euphoria and the credit excesses propelled the fantastic burst of paper wealth that, in its wake, generated the unsustainable, huge imbalances and maladjustments in the economy and the financial system, and whose predetermined fate is a sudden, violent reversal. But these macro follies were topped by the corporate micro follies guided by the preposterous shareholder value cult. A closer look at balance sheets and profit-and-loss accounts, as pointed out earlier, reveals them.

CONTINUOUS CREDIT DELUGE

Pondering the further economic development in the United States, yet another extremely unusual feature strikes the eye. The economy's sharp slowdown has been happening and continues to worsen in spite of continuous massive infusions of money and credit. The Fed has just released second-quarter credit data, and it makes fascinating and discomforting reading. In the face of a stagnating economy, total net credit market borrowing increased at an annual pace of $1.8 trillion to $28.3 trillion. This is just below the $1.9 trillion rate during the first quarter and compares to last year's $1.75 trillion net increase over the whole year.

The "non-federal" sector borrowed at the second-heaviest annual pace of $1.25 trillion, led by record private household-borrowings ($661 billion annualized — or 9.3% growth rate), while non-financial corporate business increased net bond issues at a record $424 billion pace, compared to 1999's record $230 billion issued. The "rest of the world," in other words, foreign investors, purchased approximately 45% of total corporate bonds issued during the second quarter. Total corporate borrowings grew at a 7.3% rate, up from the first quarter's 4.8%. Completely undeterred by the growing signs of economic weakness, the American financial system has thus kept expanding at record speed. For sure, tight credit cannot be blamed for this downturn. How will the lenders react when they begin to realize that the downturn is continuing?

It is shocking and frightening to observe that the economy and the stock market have completely failed to show the slightest response to this continuous credit deluge. Where, then, has all the money gone? It suggests a general rise in the demand for money. Seeing a worsening economy, corporations and investors simply want to replenish the cash balances that they have badly depleted during the boom years. It's a perfectly normal phenomenon. For the time being, the build-up is largely taking place through borrowing. But there comes a point in this process when the desire for higher liquidity increasingly cuts into expenditures.

Many American economists like to trumpet that a central bank can simply print money. It's a silly slogan. Printing money is easy, but getting it into the coffers of people or businesses wanting to spend it, that's difficult.

This boom bore no relationship to the economy's rapidly deteriorating fundamentals. Just two figures tell the real story: Total financial and nonfinancial credit growth amounted to $4.6 trillion in the first half of the 1990s, and to $8.6 trillion in the second half. This compared with $2.5 trillion nominal GDP growth during the latter period. For each dollar added to GDP there were $3.4 added to credit.

CONCLUSIONS:

In this letter, we have undertaken a comprehensive analysis of the U.S. economy's pattern of growth since 1995, when the trumpeted new paradigm shift supposedly started. Our guideline was that the crucial test of all economic policies and measures, from a long-term perspective, is their impact on investment resources and investment incentives (profits). There never was a New Economy.

Measured by what happened to these two crucial ingredients, the U.S. economy's pattern of growth during these boom years was an outright disaster, as private consumption expanded at the expense of net investment, associated in addition with skyrocketing foreign indebtedness. The claimed productivity and profit miracles resulted from fraudulent statistics.

We identified three chief causes of this disastrous development: *first*, exorbitant money and credit creation; *second*, the shareholder value follies emphasizing quick expansion at the expense of capital investment into new production capacity; and *third*, a profitless new technology involving too little capital spending.

Over the past year and a half, the U.S. economy has suffered severe economic disappointments and financial reversals. The recovery, generally predicted for this year's second half, has failed to materialize. But this is causing little worry. The consensus sees nothing worse than a postponement of the recovery until 2002. Consensus forecasts for the year as a whole are presently for 2.6% real GDP growth. That is, new paradigm illusions about the U.S. economy prevail.

But the big interest rate and tax cuts have miserably failed to even slow down the U.S. economy's contraction, and with it the rest of the world economy.

The economic slowdown in the United States has been in full motion for almost a year. The horrific events of Sept. 11 have probably triggered an acceleration of the ongoing downturn. However, they are definitely not its underlying cause.

The recognition that the U.S. economy is in the grips of a prolonged systemic economic/financial crisis has barely started. The worst part of the stock market's crash and the economy's downturn will only begin when people begin to realize the dangerous, systemic nature of this crisis.

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